REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

A REVIEW OF THE PORT OF SAN FRANCISCO'S STATE BOND OBLIGATIONS AND COMPETITIVE TRADE POSITION

P-635

MARCH 1987

REPORT BY THE

OFFICE OF THE AUDITOR GENERAL

P-635

A REVIEW OF THE PORT OF SAN FRANCISCO'S STATE BOND OBLIGATIONS AND COMPETITIVE TRADE POSITION

MARCH 1987

Telephone:
(916) 445-0255

STATE OF CALIFORNIA
Office of the Auditor General
660 J STREET, SUITE 300
SACRAMENTO, CA 95814

Thomas W. Hayes
Auditor General

March 26, 1987 P-635

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the Port of San Francisco's ability to meet its state bond obligations and its competitive trade position. Our analysis indicates that the Port can meet its state bond payments by either paying off the bond balance of $15.6 million with its surplus funds or by placing $3.8 million of its surplus in an irrevocable trust to meet its payments scheduled in the future. Our analysis also indicates that both the total tonnage of cargo passing through the Port of San Francisco and the Port's share of tonnage shipped through Bay Area ports have declined since 1980.

Respectfully submitted,

Kurt Sjoberg

for THOMAS W. HAYES
Auditor General

TABLE OF CONTENTS

SUMMARY

RESULTS IN BRIEF

The Port of San Francisco (Port) can meet its state general obligation bond payments by either paying off the bond balance of $15.6 million with over $17.8 million in surplus funds and insurance proceeds or by placing $3.8 million of its surplus in an irrevocable trust to meet payments scheduled in the future. The $3.8 million is the debt remaining in fiscal year 1993-94, the year in which the Port could encounter difficulty in making the payments with revenues available for bond payments if increases in revenues and expenses since fiscal year 1980-81 continue at the same rate.

Port officials believe that the Port will have no difficulty meeting future state bond obligations. However, they are willing to recommend that the Port Commission reserve $3.8 million of the Port's surplus to assure the State that the Port will be able to make its state bond payments in the future.

Our review of the Port's competitive trade position compared with other ports shows the San Francisco customs district has maintained its share of the total tonnage of cargo shipped through west coast ports since 1980. However, the San Francisco customs district has not maintained its share of the total value of cargo shipped through west coast ports since 1980. The total tonnage of cargo passing through the Port of San Francisco and the Port's share of cargo tonnage shipped through Bay Area ports have declined since 1980. Nevertheless, recently, the Port has been successful both in increasing its tonnage and market share of cargo from regularly scheduled shipping companies and also in maintaining its share of the value of the cargo shipped through the ports of the same customs district.

BACKGROUND

In February 1969, the State of California transferred the Port of San Francisco in trust to the City and County of San Francisco under the terms of the Burton Act. The State Lands Commission reviews port activities to ensure compliance with the mandates of the Burton Act. Use of port lands is also regulated by the McAteer-Petris Act, enacted in 1969, which empowers the Bay Conservation and Development Commission (BCDC) to oversee the use of the San Francisco Bay and its surrounding lands.

These two acts regulate the development of port property, including the developments of the Ferry Building Complex (complex) and Piers 1½, 3, and 5. The Ferry Building project would rehabilitate the Ferry Building, the adjacent Agriculture Building, and Pier 1. The Piers 1½, 3, and 5 project would rehabilitate those facilities for public and commercial uses.

The Port of San Francisco currently is responsible for three separate bond issues amounting to over $186.2 million in principal and interest. As well as city general obligation bonds and revenue bonds, the Port is responsible for general obligation bonds issued by the State during the time that the State had responsibility for the Port. At the time of our review, the state bonds amounted to approximately $16.7 million in principal and interest. However, if the State chose to redeem these bonds sooner, the balance of the principal and interest due would be approximately $15.6 million. The last of these bonds will mature in fiscal year 1998-99. While the Port has subordinated all bond issues to the state general obligation bonds and has assumed responsibility for these bonds, the State Attorney General has indicated that the State remains responsible for their payment should the Port fail to meet its obligations to the bondholders.

PRINCIPAL FINDINGS

The Port of San Francisco Can Meet Its State General Obligation Bond Payments

The Port's ability to meet its future state bond payments depends on its ability to maintain its revenues at a higher level than its expenses. The discontinued development of the Ferry Building Complex will not adversely affect the Port's ability to meet its state bond payments because the Port receives more from the complex's current leases than it would if the Continental Development Corporation (corporation) developed the complex. While the present agreement between the Port and the corporation is not as financially beneficial to the Port as maintaining current operations, it is possible that the Port could develop the complex and benefit better financially under a different agreement. However, the discontinued development of Piers 1½, 3, and 5 will adversely affect the Port's ability to meet its state bond payments because the Port would earn more revenue if this area were developed. Also, if the Port's estimate of the amount of and responsibility for deferred maintenance at port facilities is correct, the deferred maintenance should not affect the Port's ability to meet its state bond payments because the Port is currently performing its deferred maintenance and funding this work from its operating expenses.

However, our analysis indicates that it is uncertain that the Port can meet future state bond payments. Although the Port has never operated at a deficit during the 17 years since the State transferred the Port to San Francisco, if the average rate of increase for port revenues and expenses continues as it has since fiscal year 1980-81, port expenses would exceed revenues in fiscal year 1992-93, when the unpaid balance on the state bonds is still $3.8 million.

If the Port chose, it could pay the entire state bond debt immediately with unrestricted

and unencumbered surplus funds and uncommitted insurance reimbursements. However, we concur with the Port's executive director that this would not be a prudent use of the Port's financial resources. Although the executive director believes that the Port will have no difficulty meeting future state bond obligations, he has indicated that he is willing to recommend that the Port Commission reserve $3.8 million of its surplus in an irrevocable trust in an effort to assure the State that the Port will be able to meet future payments.

The Port of San Francisco's Share of Cargo Tonnage Shipped Through Bay Area Ports Has Declined Since 1980

Annual statistics indicate that the San Francisco customs district has maintained its share of the total tonnage of cargo shipped through west coast ports since 1980 although the district's total tonnage dropped 7 percent between 1980 and 1985. However, the San Francisco customs district has not maintained its share of the total value of cargo shipped through west coast ports since 1980. Within the San Francisco customs district, the Port of San Francisco's share of total tonnage shipped through the district's ports has declined slightly since 1980. However, the Port has maintained its share of the total value of the cargo shipped through the ports of the district. Further, although total tonnage through the Port has declined since 1980, the Port's tonnage and market share of cargo from regularly scheduled shipping lines have increased in the customs district.

RECOMMENDATIONS

We recommend that the Port of San Francisco pay its state bond debt by taking one of the following actions:

- Pay its state bond debt immediately by providing an amount sufficient to cover the remaining principal and interest on the state general obligation bonds. The Port should

pay this amount to the State Treasurer's Office, allowing the State to make all future payments on this debt; or

- Enter into a written agreement with the Department of Finance to put in a reserve account with the San Francisco City Controller an amount equal to that which the Port will owe on the bonds in fiscal year 1993-94. The Port may not draw upon this money without the written consent of the Department of Finance. This agreement should allow the Port to earn interest on the reserve and should also allow the Port to reduce this reserved amount as the amount of bond principal and interest due after fiscal year 1992-93 is gradually reduced.

AGENCY COMMENTS

The Port's executive director disagrees that there is any uncertainty that the Port will meet its state general obligation bond payments or any other bond obligations. However, he reiterated his willingness to recommend to the Port Commission that it set aside $3.8 million to assure the State that the Port will make these payments. The executive director also feels that the report's focus on the Port's competitive trade position since 1980 overlooks the Port's accomplishments in the ship repair, passenger, and fishing markets.

INTRODUCTION

The Port of San Francisco (Port) is a deepwater port that extends for 7.5 miles along the western shore of the San Francisco Bay. The Port serves a variety of commercial, recreational, and maritime purposes. The northern waterfront contains developments such as shops and restaurants, as well as maritime industries such as commercial fishing and cruise ship terminals. Stretching south along the western shore is the Waterfront Promenade. Opened in 1982, this area allows the public access to the bay. The Port's major maritime operations are concentrated in the Port's southern region. These activities include ship repair and transfers of liquid cargo and dry cargo.

Before February 1969, the Port was owned by the State of California and administered by the San Francisco Port Authority, a state agency. In February 1969, the Burton Act, Chapter 1333 of the Statutes of 1968, as amended, transferred the Port in trust to the City and County of San Francisco. When a property is transferred in trust, the transferee holds and administers it for the benefit of another. The Burton Act allowed the City and County of San Francisco to use revenues from port lands to encourage private investors to develop port property for purposes of the "highest and best use in the public interest." Although the Burton Act did not specifically define "highest and best use in the public interest," the act did reserve the right for the State Legislature to amend, modify, or revoke, in whole or in part, the transfer of lands provided that the State would assume all lawful obligations related to the land.

To ensure that the City and County of San Francisco uses land at the Port according to the terms of the Burton Act, the State Lands Commission reviews specific proposals for the use of port land. The commission regards the Burton Act as a trust, and the commission determines whether each proposal is in keeping with its own interpretation of the Burton Act and other interpretations decided by the courts.

The use of port lands is also governed by the McAteer-Petris Act. The McAteer-Petris Act, enacted in 1969, continued the existence of the San Francisco Bay Conservation and Development Commission (BCDC), a commission established by legislation in 1966. The BCDC issues and denies permits, after public hearings, for any proposed project that uses fill or extracted materials or that makes substantial changes in any water, land, or structure within the BCDC's jurisdiction. Its jurisdiction generally includes all the port lands within 100 feet of the shore line. The BCDC produced the San Francisco Bay Plan that states the BCDC's major policies, and the McAteer-Petris Act grants the BCDC the authority to carry out this plan.

Finally, the Port is subject to the planning policies of the City and County of San Francisco. The City and County of San Francisco has developed a comprehensive plan for development in San Francisco, and two sections of this plan specifically apply to port lands. These sections, jointly developed by the city and the BCDC, indicate to

private enterprises what kinds of development the city is seeking at the Port. The city requires that these sections of the plan be implemented.

These two sections of the plan govern the development of port property, including current plans for the development of the Ferry Building Complex (complex), in an agreement with the Continental Development Corporation (corporation), and Piers 1½, 3, and 5, in an agreement with Pier Associates. The Ferry Building project, at a proposed cost of $185 million, would involve the rehabilitation of the Ferry Building, built in 1898, the adjacent Agriculture Building, and Pier 1. The Piers 1½, 3, and 5 project would involve the rehabilitation of these port facilities for public and commercial uses at an expected cost of between $20 million and $25 million.

The administrative control of the Port is the responsibility of the Port Commission. The Port Commission, composed of five members appointed by the mayor, is required to plan, build, and maintain facilities and also to develop and maintain programs that increase the Port's commerce and improve upon its waterfront facilities. The executive director of the Port, also appointed by the mayor, serves as the chief executive of the Port Commission. The executive director is responsible for implementing the Port Commission's plans and decisions. The executive director administers an organization known as the Port of San Francisco. The Port, which has department status in the city and county administrative structure, manages all of the offices and activities placed under the jurisdiction of the Port Commission.

The Port currently operates with a budget of approximately $33.6 million and a staff of 229. The Port obtains most of its revenues from commercial sources, such as leases or licenses given to private parties for the use of port property, and from maritime sources, such as charges for docking ships and storing cargo on port lands. Since fiscal year 1981-82, commercial sources have surpassed maritime sources as the Port's primary generator of revenue. In fiscal year 1985-86, commercial sources accounted for 40 percent of the Port's revenues, and maritime sources accounted for 30 percent of the Port's revenues. Table 1 shows the annual revenues and expenses for the Port since fiscal year 1980-81.

TABLE 1

CASH REVENUES AND OPERATING EXPENSES
PORT OF SAN FRANCISCO
FISCAL YEARS 1980-81 THROUGH 1985-86
(FIGURES IN THOUSANDS OF DOLLARS)

	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86
CASH REVENUES						
Commercial revenue	$ 9,353	$10,926	$12,076	$14,626	$14,458	$14,691
Maritime revenue	10,296	10,455	11,514	10,687	12,667	11,138
Commercial power	1,422	2,035	2,054	1,440	1,207	1,145
Other	610	448	716	868	789	2,437
Interest income	2,598	2,489	3,442	2,839	5,557	7,324
Total Revenues	24,279	26,353	29,802	30,460	34,678	36,735
OPERATING EXPENSES						
Operations	5,816	4,987	6,977	4,725	7,555	9,591
Maintenance and engineering	4,948	6,432	7,381	8,404	10,296	9,592
Commercial power	1,088	1,616	1,622	1,152	965	924
Fireboat operations	648	797	862	967	1,013	927
Total Operating Expenses*	12,500	13,832	16,842	15,248	19,829	21,034
Net Revenues Available for Debt Service	$11,779	$12,521	$12,960	$15,212	$14,849	$15,701

*Total operating expenses less depreciation.

The Port operates as an "enterprise" department and thus should generate revenues sufficient to support its operations. In 1969, when the State relinquished its jurisdiction, the Burton Act required the Department of Finance to determine the fund or funds that the Port Commission would use in operating the Port. Now, the Burton Act requires that the Port send its annual financial reports to the Department of Finance.

The Port currently is responsible for three separate bond issues amounting to $186.2 million in principal and interest. The Port is responsible for $31.9 million in principal and interest on city general obligation bonds, the last of which matures in fiscal year 2004-05. These city bonds were issued in 1973, and the original principal amounted to $34 million. In addition, the Port is responsible for $137.5 million in principal and interest on revenue bonds, the last of which matures in fiscal year 2008-09. The revenue bonds were first issued in 1969, and the original principal was $62.5 million. Finally, the Port is responsible for state general obligation bonds.

The state general obligation bonds were issued by the State during the time that the State had responsibility for the Port. When the State issued these bonds in 1915, the principal amounted to $80 million. When the Port assumed the responsibility for these bonds, the principal amounted to $54.7 million. At the time of our review, these bonds amounted to approximately $16.7 million in principal and

interest. If the Port chose to pay the entire bond debt immediately, the balance of the principal and interest due would be approximately \$15.6 million. The last of the state general obligation bonds will mature in fiscal year 1998-99.

The Port has given priority to the state general obligation bond payments. Several times a year, the Port makes the payments through the State Treasurer's Office, which then pays the bondholders. While the Port has assumed responsibility for these bonds, the State Attorney General recently indicated that the State remains responsible to the bondholders for the payment of principal and interest. Therefore, should the Port fail to make its payments on these bonds to the State, the State would be responsible for making them.

SCOPE AND METHODOLOGY

The first purpose of this audit was to determine the ability of the Port to pay off the state general obligation bonds. To this end, we reviewed the financial effect on the Port of the termination of work on the development of the Ferry Building Complex and Piers 1½, 3, and 5. Also, we reviewed the financial impact of maintenance that was deferred but that is necessary to sustain the Port's revenues. We focused on the Port's ability to meet its state bond payments only; we did not include in our review the Port's other bond payments. The second purpose of our audit was to determine the competitive trade position of the Port in relation to other ports in the San Francisco Bay Area and on the west coast of the continental United States.

To determine whether the Port can meet the payments for its state general obligation bonds, we reviewed its annual reports and financial audits since 1969, the year in which the City and County of San Francisco assumed responsibility for the Port. We also reviewed the regulations of the State Lands Commission and the BCDC, both of which have jurisdiction over the use of port land. We examined plans developed for the port areas by San Francisco's City Planning Department and examined the Port's plans for the development of port property, including its request for developers' proposals and the design development agreements for selected projects at the Port. We also reviewed both the restrictions faced by the Port in the development and use of its property and also the current expenses incurred by port locations scheduled for future development.

We also examined the different types and amounts of bonds now outstanding from the Port. Further, we determined whether the other bond payment obligations were subordinated to the state general obligation bond payments. We examined the policies of the Port and the City and County of San Francisco toward deficit budgets at the Port, and we examined the efforts of the Port to gain new maritime and other clients. We also reviewed the potential financial effect on the Port of the proposed development of the Ferry Building Complex and Piers 1½, 3, and 5.

In reviewing the financial impact of the once deferred but necessary maintenance needed to sustain the Port's revenues, we

examined the Port's documents, records, and schedules supporting the $199.8 million in deferred maintenance cited by the Port to the chief administrative officer of the City of San Francisco in 1985. We reviewed leases, contracts, development plans, proposals, and other documents to verify the reasonableness of the Port's allocation of responsibility for deferred maintenance among the Port, tenants, and other entities involved in the work. We also reviewed the amount of deferred maintenance cited by the Port as its own responsibility and examined the schedule used by the Port to determine when and where its work will be performed. We examined various records to determine whether the Port is performing this work according to schedule and whether the Port is funding this work from its operating expenses rather than from capital improvement funds or other funds. We did not hire an engineering consultant to independently determine whether the Port's 1985 estimates of deferred maintenance were accurate.

To determine the competitive trade position of the Port in relation to other ports in the San Francisco Bay Area and on the west coast of the continental United States, we reviewed figures from the United States Department of Commerce for the annual amount and value of liquid and dry cargo tonnage passing through these ports since 1980. We compared these figures for the San Francisco Bay Area with the figures for the San Diego, Los Angeles, Portland, and Seattle areas of the United States' west coast. In addition, we compared these figures for the Port of San Francisco with the figures for each of the ports in the San Francisco Bay Area. We also reviewed the financial statements

and the annual reports for fiscal years 1980-81 through 1985-86 for the Port of San Francisco and for eight ports on the west coast. However, we did not attempt to determine the causes for the trends in these figures, and we did not examine other port activities such as fishing or ship repair.

CHAPTER I

THE PORT OF SAN FRANCISCO CAN MEET ITS STATE GENERAL OBLIGATION BOND PAYMENTS

The Port of San Francisco (Port) can meet its state general obligation bond payments by either paying off the bond balance of $15.6 million with over $17.8 million in surplus funds and insurance proceeds or by placing $3.8 million of its surplus in an irrevocable trust to meet payments scheduled in the future. The $3.8 million is the debt remaining in fiscal year 1993-94, the year in which the Port could encounter difficulties in making the payments with revenues available for bond payments if increases in revenues and expenses since fiscal year 1980-81 continue at the same rate.

The termination of work on the Ferry Building Complex (complex) will not adversely affect the ability of the Port to meet its state general obligation bond payments because, under current economic conditions, the Port receives more in rent now than it would if the Continental Development Corporation (corporation) developed the complex. However, the Port and its contractors cannot continue the development of Piers 1½, 3, and 5 because of the Bay Conservation and Development Commission's (BCDC) restrictions. This termination of development will adversely affect the ability of the Port to meet its state general obligation bond payments since the Port would receive more under its contract with Pier Associates than it now receives from the piers. Also, if the Port's estimates of the cost of deferred maintenance are correct, deferred maintenance should not affect the

ability of the Port to meet its state bond payments because the Port is currently performing scheduled deferred maintenance with funds budgeted for operating expenses.

The Port's executive director maintains that the Port will have no difficulty meeting future state bond obligations. However, he has stated that he is willing to recommend that the Port Commission reserve, in an irrevocable trust managed by a reputable trustee, a portion of the Port's unrestricted surplus equaling the $3.8 million unpaid balance to assure the State that the Port will meet its state general obligation bond payments after 1994.

The Development of the Ferry Building Complex

In the late 1970's, the Port of San Francisco began plans to renovate and convert the Ferry Building Complex into a modern ferry terminal, a world trade center, and an office building. In April 1980, the Port signed an agreement with the Continental Development Corporation to prepare a development plan. The agreement outlined the conditions under which the complex was to have been leased to the corporation. However, after the corporation encountered difficulties in proceeding with its development of the complex, the Port and the corporation entered into litigation because the Port charged the corporation with failure to meet the terms of the agreement. The corporation then claimed the Port did not fulfill its commitments in the project.

The agreement between the Port and the corporation indicated that the corporation would prepare a development plan that would describe how it would develop and operate the complex. This plan was to be the last of a series of steps including the inspection of the complex site and proposed financing and specifications for the development of the complex. To the extent that the corporation fulfilled these and other obligations included in the agreement, the Port agreed to lease the complex to the corporation. The conditions of payment state that the corporation would pay the Port two kinds of rent, minimum rent and percentage rent, over the course of different periods. The minimum rent would be the least amount of rent that the Port could expect from the corporation during any period. The percentage rent would be the additional rent that the Port could expect from the corporation, depending upon the vacancy rate of the renovated complex and the corporation's net operating income from the complex.

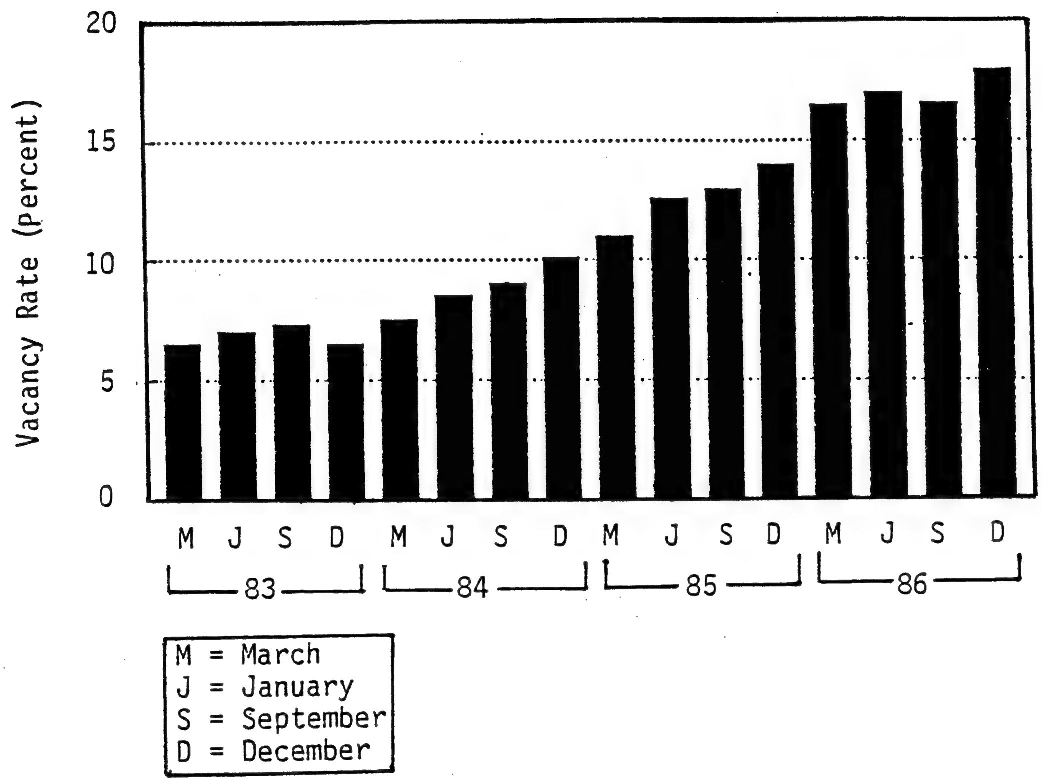
The complex consists of the Agriculture Building, Pier 1, and the Ferry Building, which was first constructed in 1898 and includes the World Trade Center and offices for the Port of San Francisco. Currently, the complex has a total of 280,677 square feet of office space and a vacancy rate of 11.7 percent, excluding the Port's office space. Also, this complex has an average annual rental cost of $11.28 per square foot. In contrast, the vacancy rate in the downtown district of San Francisco (where the complex is located) is 18.1 percent, and its average annual cost per square foot is $18 to $25.

As long as the current vacancy rate remains above 5 percent in the downtown district of San Francisco, the Port will continue to receive more revenue from the current leases in the complex than it would expect to receive under the agreement with the corporation. Under the current agreement with the corporation, the Port would receive a minimum annual income that would start at $450,000 and increase through the next five years until it reached a maximum of $600,000. The Port could receive additional revenue from the corporation if the vacancy rate in the complex dropped below 5 percent. The calculation of this vacancy rate, according to the agreement with the corporation, excludes the spaces occupied by both the Port of San Francisco's administrative offices and two of the Ferry Building's largest current lessees, the World Trade Club and Limbach, Limbach, and Sutton, a private law firm.

At the time of our review, the vacancy rate in the downtown San Francisco area was approximately 18.1 percent. As Chart 1 shows, the vacancy rate in downtown San Francisco rose almost steadily from approximately 6 percent in March 1983 to a peak of over 18 percent in December 1986. Therefore, the office vacancy rate for downtown San Francisco has not been close to the 5 percent stated in the agreement for three years.

CHART 1

OFFICE VACANCY RATE
DOWNTOWN SAN FRANCISCO
1983 THROUGH 1986



*Source: "Coldwell Banker Office Vacancy Index, December 31, 1986"

In fiscal year 1985-86, the Port received over $2.4 million in revenues from its rental agreements and incurred approximately $645,000 in expenses from the complex, resulting in a net revenue of approximately $1.8 million. If the Port were to sustain similar net revenues after meeting anticipated expenses, including scheduled maintenance, beginning with fiscal year 1987-88 it would earn net revenues totaling approximately $21.6 million by fiscal year 1998-99 when the state bonds mature. In no year would net revenues drop below $1.7 million.

In contrast, if the vacancy rates in San Francisco continue to remain at over 5 percent, if the Port continues to use 35,000 square feet of office space, and if the corporation were to begin development on the complex and thus require the Port to vacate its offices in fiscal year 1987-88, we estimate that the Port would realize net losses of over $257,000 in the first year of its lease with the corporation. These losses would occur because the Port would have to rent temporary office space at current market rates and then have to pay current market rates for its new spaces in the Ferry Building. (Currently, the Port does not pay rent for the space that it occupies in the complex.) These losses would continue through fiscal year 1998-99 when the state bonds mature. Moreover, these losses do not reflect the moving costs that the Port would incur in relocating its offices during renovation. We estimate that, as a result of these losses, the Port would realize net losses of approximately $4.2 million by fiscal year 1998-99 in contrast to the approximately $21.6 million in revenues the Port would receive if it continues to lease the complex until 1998-99, as it is doing now.

Therefore, we conclude that the termination of development work on the complex will not adversely affect the ability of the Port to meet its state general obligation bond payments. However, while the present agreement between the Port and the corporation is not as financially beneficial to the Port as maintaining current operations, it is possible that the Port could develop the complex and benefit better financially under a different agreement. Port representatives

indicate that they are not certain of either the outcome of the litigation on the complex or when this litigation will conclude.

At the end of our review, we met with the project manager and an attorney for the corporation. The project manager provided us with the corporation's estimate of the revenue that the Port would receive for developing the complex. Although we did not audit the corporation's figures, we did note that the estimate differed from our analysis in at least three ways. First, the corporation assumes in its estimate that after the fifth year of operation, the complex would achieve 95 percent occupancy despite the trend in vacancy rates we cited earlier. The 95 percent occupancy rates could mean higher revenues for the Port. Second, the corporation assumes that there would be additional revenue from parking facilities, which the corporation maintains the Port Commission approved for inclusion in the development plan. Port officials deny that the Port Commission did so. Third, the estimate does not show a reduction of the Port's revenues by the amount of rent that the Port would have to pay for its own office space.

However, discounting these differences and using the corporation's figures does not alter our conclusion that the termination of development work on the complex will not adversely affect the ability of the Port to meet its state general obligation bond payments. We have not altered our conclusion because the complex's minimum annual net revenue of $1.7 million exceeds by nearly $700,000 the highest annual revenue estimated by the corporation.

The Development of Piers 1½, 3, and 5

Piers 1½, 3, and 5 are situated on San Francisco's northern waterfront, immediately north of the Ferry Building Complex. The site now consists of three piers with buildings that are rented monthly for office, parking, and storage uses. In February 1985, the Port solicited developers for plans to develop these piers into office buildings and public access areas. The Port's goal is to improve the piers for commercial and recreational activities. The Port's solicitation, developed with the San Francisco City Planner's Office and the San Francisco Bay Conservation and Development Commission, listed the improvements a developer must make to obtain a lease for the site.

On June 10, 1985, a group called Pier Associates, consisting of three companies, submitted the winning proposal that included plans for the conversion of the area into offices, maritime facilities, open spaces for the public, and other facilities. Pier Associates agreed to finance the project and manage all construction. The individual companies of the development group would lease portions of these new facilities while Pier Associates itself would search for tenants for other portions. The Port would receive a minimum monthly rent from Pier Associates plus a percentage rent that would depend upon the occupancy rate of the new structures.

However, engineering studies revealed that construction on Pier 3 would entail new material or new fill in the San Francisco Bay, and under the McAteer-Petris Act, the BCDC can permit new bay fill only for certain "water-oriented" uses specified in the law, such as ports, water-related industries, and wildlife refuges. The BCDC determined that housing and offices, two kinds of facilities for which large areas of the San Francisco Bay were filled in the past, cannot be classified under "water-oriented" uses. Consequently, Pier Associates has not obtained the BCDC's permit for office construction on Pier 3. In a joint effort to overcome this problem, the BCDC and the Port are proposing new legislation that would amend the McAteer-Petris Act, thus permitting uses other than "water-oriented" ones on Pier 3. If this legislation does not become law, the Port will be left with no option but to solicit new plans for Pier 3 that conform to the McAteer-Petris Act.

Our analysis indicates that the Port would receive more from the development of these piers than it does from the current leases on them. If Pier Associates developed the piers and paid the rent stipulated in its agreement with the Port, and even if vacancy rates remained at their current level of approximately 18.1 percent in downtown San Francisco, the Port would receive over $477,000 annually in net revenue from fiscal year 1986-87 until the state bonds mature in fiscal year 1998-99. In addition, the Port would no longer be responsible for any expenses and would also receive more revenue depending upon the development's occupancy rate. If the piers are not

developed, the Port would continue to receive approximately $250,000 annually in net revenue, which would still result in a net profit. However, development of the piers would mean a greater net profit and would enhance the Port's ability to meet its state general obligation bond payments.

Deferred Maintenance at the Port of San Francisco

On November 25, 1985, the Capital Improvement Advisory Committee, established by the San Francisco Administrative Code, submitted to the San Francisco mayor and board of supervisors a report entitled "A Study of the Infrastructure of the City and County of San Francisco." This report listed the amount of deferred maintenance at the Port of San Francisco as approximately $200 million. To determine whether the amount of deferred maintenance at the Port would affect the Port's ability to meet its state general obligation bond payments in the future, we defined deferred maintenance as the maintenance required to bring a project needing repair up to a safe and functional condition so that it could be used as intended to support port operations.

The estimate of deferred maintenance originated from the Port's executive director, who stated in a brief memorandum dated July 30, 1985, that the deferred maintenance at the Port equaled $199.8 million and that there would be additional annual maintenance costs of $15 million should all the deferred maintenance be completed.

This correspondence did not, however, indicate the type of deferred maintenance at the Port, the location of the deferred maintenance, or whether the Port itself was responsible for the deferred maintenance work. Moreover, this memorandum did not define deferred maintenance, which contributed to conflicting interpretations of what maintenance work had to be done. The budget analyst for the city's board of supervisors later audited the Port of San Francisco. In his report, dated May 1986, the analyst cited the approximately $200 million figure and noted that the Port had no accounting system for recording maintenance costs at individual locations. The report also noted that the Port had no comprehensive plan for the development of its commercial property, which is part of the deferred maintenance work.

The Port is now implementing an accounting system that will allow it to record costs, as well as revenues, at individual locations throughout the Port. Also, the Port has developed a plan for accomplishing the deferred maintenance work by dividing the approximately $200 million cited in the city's infrastructure report into six different categories. These categories indicate the amount of deferred maintenance at each port location and also the organizations or individuals responsible for the work. A $31.2 million portion of the approximately $200 million is the responsibility of current tenants leasing or renting port property. Another $49.3 million in deferred maintenance will be the responsibility of future developers. A portion is also assigned to the Port. The Port estimated that over the next 20 years it would be responsible for $23.2 million in deferred maintenance work at different port locations.

The Port further listed, as part of the $199.8 million amount, $27 million in capital improvements and $2.1 million in demolition of unneeded port facilities, both to be funded by revenue bonds issued by the Port. The Port has subordinated the revenue bonds to the state general obligation bonds. Finally, the Port listed $67 million in deferred maintenance that the Port termed "business decisions." These "business decisions" represented instances in which the Port would perform the deferred maintenance work only if there was a profitable purpose for such work, such as the rehabilitation of some unused port property in order to lease the property to interested parties.

We reviewed the Port's six allocations of deferred maintenance to determine whether the estimates were consistent with supporting documentation. We examined bond amounts, current appropriations, and demolition plans to determine if there were sufficient funds to support the planned capital improvements and demolition of unneeded port facilities. We also reviewed existing port agreements with contractors and proposals from contractors for future development to determine whether these agreements and proposals include provisions for the performance of the deferred maintenance work. In addition, we examined the leases and licenses of tenants at the Port to determine whether these agreements indicate that the deferred maintenance cited is the responsibility of the tenant. We examined the Port's description of "business decisions" to ensure that this work is not repair work necessary to maintain current revenues. Finally, we reviewed the Port's deferred maintenance schedule for completeness and also for

consistency with the expiration of port leases for any of the locations scheduled for work. We also determined whether the Port had completed any of this work and whether it had funded any completed work from its normal operating expenses rather than from bond funds and from other capital improvement funds.

The Port's allocation of deferred maintenance responsibilities appears to be consistent with its supporting documentation. Sufficient bond funds support planned capital improvements and demolition of unneeded port facilities. Existing port agreements with contractors and proposals from contractors for future development include provisions for the performance of deferred maintenance work. In addition, tenants' leases and licenses include provisions for the performance of deferred maintenance work. Also, the Port's "business decisions" do not include work that is necessary to protect revenues. Finally, the Port has developed a schedule for the deferred maintenance work that it will perform over the next 20 years and is working according to schedule. The Port is funding this work from its operating expenses rather than from its bond funds or from funds intended for other uses.

Although the Port's plan appears to be reasonably comprehensive, it does not consider two factors that could ultimately increase the Port's deferred maintenance expenses. The first factor is that the Port's allocation of responsibilities and costs to tenants currently leasing or renting port property assumes that the tenants

will perform all the deferred maintenance that their lease agreements call upon them to perform. However, we found that the Port had determined that two former lessees with deferred maintenance responsibilities had failed, at least in part, to meet their deferred maintenance obligations. The Port had assessed these lessees for the deferred maintenance amounts, but we were unable to determine whether the Port would be successful in collecting them because the Port had not completed negotiation with one of the lessees while, in the other case, the Port had recovered only 35 percent of the amount. The second factor is that the Port's 20-year schedule for accomplishing its own deferred maintenance responsibilities allocates the costs based on the condition of the Port's facilities in fiscal year 1985-86. The plan does not consider additional deterioration that can occur on the Port's facilities while they await their scheduled maintenance. As a result, actual costs may be higher than estimated.

Therefore, to the extent that the Port can ensure that its tenants fulfill their deferred maintenance obligations and no additional deterioration occurs on facilities scheduled for deferred maintenance work in the future, our analysis of the approximately $200 million deferred maintenance figure indicates that this deferred maintenance should not adversely affect the ability of the Port to meet its state general obligation bond payments in the future. Our conclusion is valid only if maintenance figures do not exceed the amounts cited by the Port and if the Port's specific responsibility for deferred maintenance does not exceed the $23.2 million cited in its estimate.

The Ability of the Port of San Francisco To Meet Its State General Obligation Bond Payments

If the Port chose to pay the entire bond debt immediately, it would have the resources to do so. Currently, the Port owes approximately $15.6 million in principal and interest on its state bond debt. The Port had, as of February 6, 1987, approximately $16.3 million in unrestricted, unencumbered surplus funds and $1.5 million in uncommitted insurance proceeds. These surplus funds and uncommitted proceeds total more than $17.8 million.

However, the Port's executive director has indicated that he does not want to pay off these bonds early because their interest rates are low. He has indicated that early payment would not be a prudent use of the Port's resources, and we concur with his opinion. Instead, he has indicated that he intends to use this surplus for emergencies and other uses consistent with state laws governing the Port's operations.

Nevertheless, if the Port chooses not to pay the state bonds early using its unrestricted, unencumbered surplus and insurance proceeds, it becomes less certain that the Port can meet its future state bond payments. The ability of the Port to meet its state bond payments through the bonds' maturity date depends on the Port's ability to maintain its revenues at a higher level than its expenses. The following factors should help the Port to maintain its revenues at a

higher level although other factors could also raise the Port's expenses or lower its revenues. First, the Port has never operated at a deficit during the 17 years since the State transferred the port operations to the City and County of San Francisco. Second, both the mayor and the president of the Port Commission have stated that they will not approve a Port of San Francisco budget proposal that projects expenses exceeding revenues for any fiscal year. Both officials point out that the situation has never occurred and that they will require expenditures to be reduced when necessary to ensure that a budget deficit never occurs in the future. Third, the state general obligation bonds have priority over all other bonds on which the Port must make payments. Therefore, the first expenditures will be on the state bonds before any other long-term debt is paid. Fourth, the Port plans to generate additional revenue both through commercial projects and also through new shipping lines that will call at the Port. One shipping line has already signed with the Port, resulting in an estimated $125,000 in additional revenue per year.

Conversely, expenses could rise in the future. First, more deferred maintenance work may be needed on port facilities than the Port has actually planned for. Second, while the Port has plans for increasing sources of revenues, it recently lost its largest maritime client, the Lykes Steamship Line, in March 1986. This client provided the Port with over $1 million in revenue annually.

Third, although the Port is developing a cost accounting system to better manage its expenditures, the system has not yet been implemented. Until the system is fully implemented, the Port will be less effective in determining where it may be able to decrease costs. Fourth, the ratios of the Port's net income to its operating revenue, its net operating revenue to its operating revenue, and its net income to its assets have all declined since 1984 and are lower now than in 1980. The decline of these ratios may indicate that the Port has become less efficient in its operations. Fifth, the regulatory restrictions imposed by the McAteer-Petris Act, the Burton Act, and state regulatory commissions effectively preclude the Port from developing and implementing projects that would create quick revenue, as illustrated by the discontinued development at Piers 1½, 3, and 5, even though this project would be financially beneficial to the Port.

To adhere to the state bond payment schedule using operating revenues, the Port must maintain future revenues at a higher level than future expenses. We, therefore, reviewed the last six years of port operations to determine the trends in revenues and expenses. We carried these trends out to fiscal year 1998-99, the year in which the last of the state bonds matures.

To do our analysis, we reviewed the audited statements of the Port from fiscal year 1980-81 through fiscal year 1985-86. Using compounded rates of increase for operating revenues and expenses during this period, we next identified what future operating revenues and

expenses would be if the rates of change in operating revenues and expenses continued. While making the analysis, we attempted to rely as fully as possible on historical data. Nevertheless, we did find it necessary to make two adjustments. First, in fiscal year 1985-86, the Port received an approximate $1.8 million reimbursement from an insurance company for a fire that had occurred on port property in May 1984. We excluded this reimbursement from one year's operating revenues because it caused an unusual rate of increase for revenues over the entire six years. In addition, we removed the influence of the Lyke's Steamship Line from the rate of increase in the Port's maritime revenue for the last five years of the six-year period. Removal of this influence is necessary to predict more accurately future increases in maritime revenue. However, because port recordkeeping before fiscal year 1981-82 did not identify revenues by client and the Port does not currently allocate costs by location, we were unable to identify and remove from our analysis revenues from fiscal year 1980-81 and expenses attributable to this shipping line for all six years.

We found that if the average rate of increase for port revenues and expenses were to continue as it has since fiscal year 1980-81, the Port's expenses would exceed its revenues in fiscal year 1992-93. Although the trend analysis indicates that expenses would exceed revenues in fiscal year 1992-93, the Port would be able to meet its state bond payments in that year because its interest income is sufficient to make up the shortfall. Starting in fiscal

year 1993-94, however, the Port would be unable to meet its state bond payments with net operating revenues and interest income. At that point, the state bond principal and interest balance through 1999 would be $3.8 million.

Port officials do not agree with the results of our trend analysis for several reasons. They point out that if the rates of increases for revenues and expenses are projected from 1969 when San Francisco assumed the Port's operations, the Port's expenses would never exceed its revenues. This observation is true. Nevertheless, we believe that our six-year trend analysis more accurately reflects current economic conditions and the management of the Port by the current port administration. The port officials also cite the mayor's and the Port Commission's policy against deficit budgeting as an indication that expenses will be reduced in the event of a deficit budget. In addition, they stated that many of the Port's expenditures are discretionary and could be reduced if necessary. The officials note that port expenses have never exceeded revenues. The Port has produced its own revenue and expense analysis that indicates that the Port will meet all of its bond payments in the future.

Nevertheless, the Port has indicated that it is willing to assure the State that it can meet its state bond obligations. Port officials have offered to recommend that the Port Commission reserve an amount of the Port's surplus equaling the $3.8 million balance in unpaid state bond principal and interest for fiscal year 1993-94.

These port officials have also indicated that they are willing to recommend that the Port Commission place this money in a reserve account to be mutually agreed upon by the Port Commission and the Department of Finance. The Department of Finance was originally involved in the transfer of the Port from the State to the City and County of San Francisco. Officials from the Department of Finance have expressed a similar willingness to enter into such an agreement with the Port.

CONCLUSION

The Port of San Francisco can meet its state general obligation bond payments by either paying off the bond balance of $15.6 million with over $17.8 million in surplus funds and insurance proceeds or by placing $3.8 million of its surplus in an irrevocable trust to meet payments scheduled in the future. The $3.8 million is the debt remaining in fiscal year 1993-94, the year in which the Port could encounter difficulties in making the payments with revenues available for bond payments if increases in revenues and expenses since fiscal year 1980-81 continue at the same rate.

The termination of planned work on the Ferry Building Complex will not adversely affect the ability of the Port to meet its state general obligation bond payments because the Port receives more net revenues from the complex now than it would

if the Continental Development Corporation developed it. However, the failure of the Port and Pier Associates to continue the development of Piers 1½, 3, and 5 will adversely affect the ability of the Port to make these payments because the Port would receive more net revenues if this area were developed. If the Port's estimate of the amount of and responsibility for deferred maintenance is correct, the deferred maintenance should not affect the ability of the Port to meet its state bond payments because the Port is now performing scheduled deferred maintenance with funds from its operating expenses. Port officials believe that the Port will have no difficulty meeting future state bond obligations. However, they have expressed a willingness to recommend that the Port Commission enter into an agreement with the Department of Finance to assure the State that the Port will meet its state bond payments. Port officials have offered to recommend that the Port Commission reserve an amount of the Port's surplus equaling the $3.8 million balance in unpaid state bond principal and interest for fiscal year 1993-94.

RECOMMENDATION

We recommend that the Port of San Francisco pay its state bond debt by taking one of the following actions:

- Pay its state bond debt immediately by providing an amount sufficient to cover the remaining principal and interest on the state general obligation bonds. The Port should pay this amount to the State Treasurer's Office, allowing the State to make all future payments on this debt; or

- Enter into a written agreement with the Department of Finance to reserve $3.8 million, equaling the principal and interest remaining on these bonds for fiscal year 1993-94, the year that our analysis indicates the Port could encounter difficulty making the bond payment if increases in revenues and expenses since fiscal year 1980-81 continue at the same rate. The agreement should stipulate that the city controller of San Francisco will put this money into a reserve account and that the Port may not draw upon this money without the written consent of the Department of Finance. Not only the department and the Port, but also the city controller should sign this agreement, acknowledging himself as the party responsible for the reserve account and acknowledging that he cannot release the funds without the written consent of the Department of Finance. This agreement should allow the Port to earn interest on the reserve while it is under the city controller's administration, and it should also allow the Port to

reduce this reserved amount as the amount of bond principal and interest due after fiscal year 1992-93 is gradually reduced.

CHAPTER II

THE PORT OF SAN FRANCISCO'S SHARE OF CARGO TONNAGE SHIPPED THROUGH BAY AREA PORTS HAS DECLINED SINCE 1980

The United States Department of Commerce has grouped the ports on the west coast of the continental United States into different customs districts, including the five districts of San Diego, Los Angeles, San Francisco, Portland, and Seattle. Since 1980, annual statistics on shipping from the Department of Commerce indicate that the San Francisco customs district, which includes the Port of San Francisco and the ports of Oakland and Richmond, as well as other ports, has maintained its share of the total tonnage of cargo shipped through west coast ports since 1980 although the district's tonnage has dropped 7 percent. However, the San Francisco customs district has not maintained its share of the total value of cargo shipped through the continental west coast ports since 1980. Within the San Francisco customs district, the Port of San Francisco's share of total tonnage shipped through the district's ports has declined slightly since 1980. Nevertheless, the Port has maintained its share of the total value of the cargo shipped through the ports of the district. Further, although total tonnage through the Port has declined since 1980, the Port's liner tonnage and market share in the customs district have increased.

We reviewed information on the weight and value of import and export cargos, including both dry and liquid cargo, passing through the five selected customs districts. We also reviewed information on the

weight and value of import and export cargos for the ports in these districts. We compared this information on weight and value with the same kind of information about the other customs districts in our analysis. We then compared this information about the Port of San Francisco with the same kind of information for the other ports within the San Francisco customs district. We were able to obtain information from the U.S. Bureau of Statistics for January 1980 through May 1986, the latest month that the information was available at the time of our review.

Most maritime revenues depend upon fee structures, which are based on many factors, such as cargo tonnage. According to a representative of the Department of Commerce, maritime fees such as wharfage, dockage, and demurrage may depend upon either the weight of the cargo or the value of the cargo.* According to this representative, depending on the port in question, the value of cargo may or may not be important. According to the Port of San Francisco's manager of Trade Development, the value of cargo has no effect on the maritime revenues at the Port of San Francisco. However, the cargo value figures combined with cargo tonnage figures may indicate the type of cargo being shipped through a port. Ports shipping grain, for

*Wharfage is the charge assessed against a ship's cargo. Dockage is the charge assessed against a vessel for docking at the port, and demurrage is the charge assessed against cargo that is not removed from a wharf within an allowable time.

example, may ship many more tons of cargo than a port shipping automobiles although the value of their cargos in one year may be the same.

Cargo Tonnage and Value Through West Coast Customs Districts

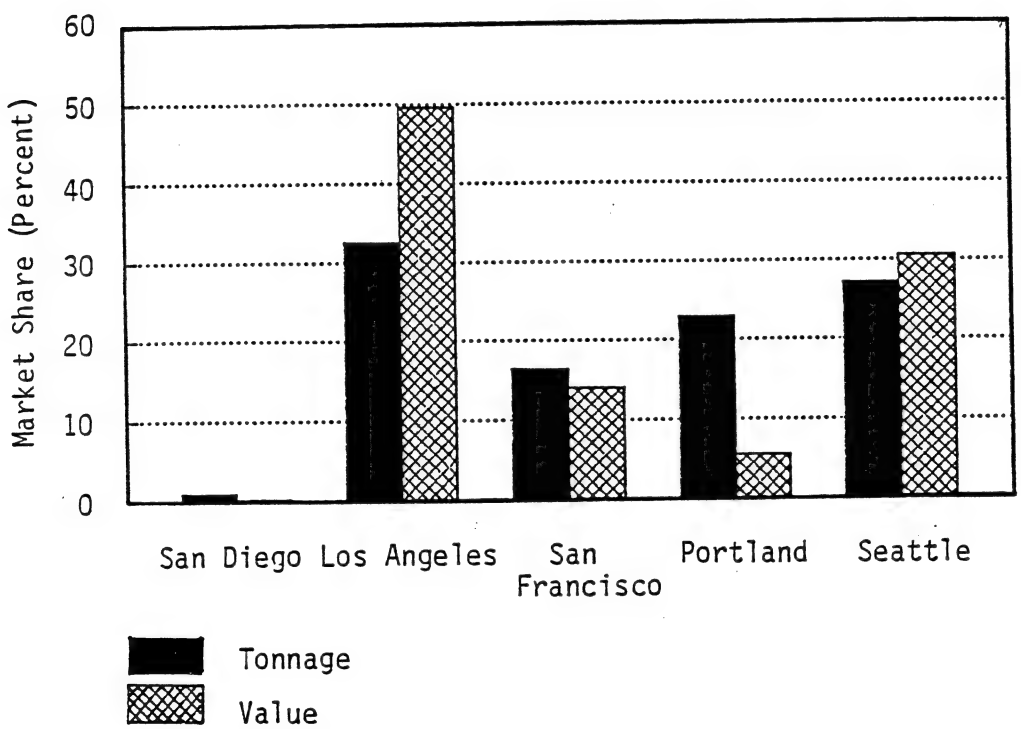
The Department of Commerce gathers statistics on the United States foreign trade through information required to be filed with the United States customs officials. The Department of Commerce then publishes these statistics, listed by United States coastal district, both monthly and annually. A coastal district includes all the ports in a certain area of the United States coast. The South Pacific coastal district, for example, comprises all ports in California and Hawaii, while the North Pacific coastal district includes all ports in Oregon, Washington, and Alaska. Within these coastal districts, the Department of Commerce lists information by the various customs districts located in each coastal district. Within each customs district, the department lists information by port. We reviewed statistics for five customs districts in two separate coastal areas; Seattle and Portland are located in the North Pacific coastal district while San Francisco, Los Angeles, and San Diego are located in the South Pacific coastal district.

The San Francisco customs district ranked fourth in cargo tonnage in both 1980 and 1986. Between 1980 and 1985, with the exception of 1984, cargo tonnage decreased from 40.684 billion pounds

to 37.873 billion pounds, a decrease of 7 percent for the district. As Chart 2 shows, in the first five months of 1986, the San Francisco customs district's market share was 16 percent, the same as it was in 1980.

CHART 2

MARKET SHARES IN CARGO TONNAGE AND VALUE
FIVE CUSTOMS DISTRICTS
JANUARY THROUGH MAY 1986



However, since 1980, the San Francisco customs district was not able to maintain its market share of the value of cargo shipped through these five customs districts. The San Francisco customs district ranked third in 1980, with 21 percent of the value of all cargo that was shipped through the five customs districts. For the

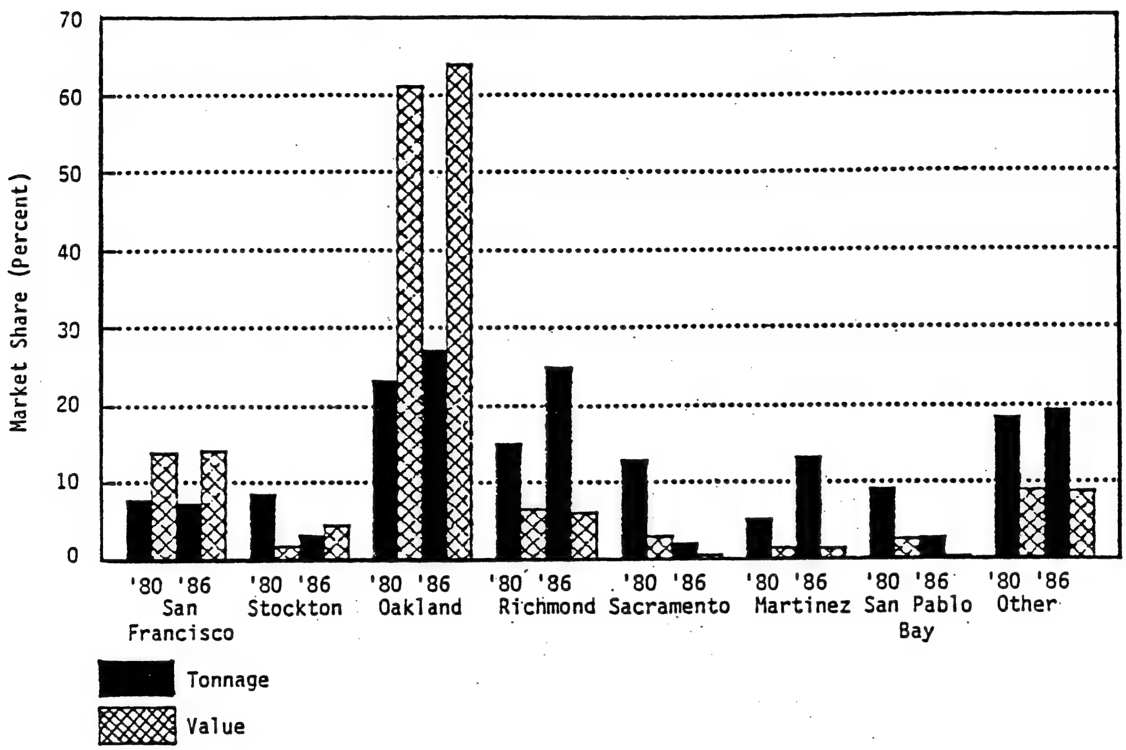
first five months of 1986, the San Francisco customs district still ranked third among these customs districts but had only 14 percent of all the cargo value shipped through the districts.

Cargo and Cargo Value Activity in the San Francisco Customs District

We also compared the amount of cargo and the value of cargo passing through the Port of San Francisco with the amount and value of cargo passing through the other 15 ports in the San Francisco customs district. As Chart 3 shows, the Port of San Francisco's share of the cargo tonnage shipped through the ports in the San Francisco customs district declined slightly from 7.7 percent in 1980 to 7.2 percent in May 1986. Nevertheless, its ranking climbed from sixth among the ports to fourth among the ports during the same period.

CHART 3

CURRENT MARKET SHARES
CARGO TONNAGE AND VALUE
PORTS OF THE SAN FRANCISCO CUSTOMS DISTRICT
1980 COMPARED TO 1986



Note: 1986 figures are for the first five months only.

Also, the amount of cargo tonnage that passed through the Port of San Francisco declined from 1980 to 1985, the last full year in which these figures were available. Chart 4 indicates that the total tonnage that passed through the Port of San Francisco dropped from 3.144 billion pounds in 1980 to 2.616 billion pounds in 1985; this represents a decline of 16.8 percent.

CHART 4

AMOUNTS OF CARGO SHIPPED THROUGH THE PORT OF SAN FRANCISCO 1980 THROUGH 1985

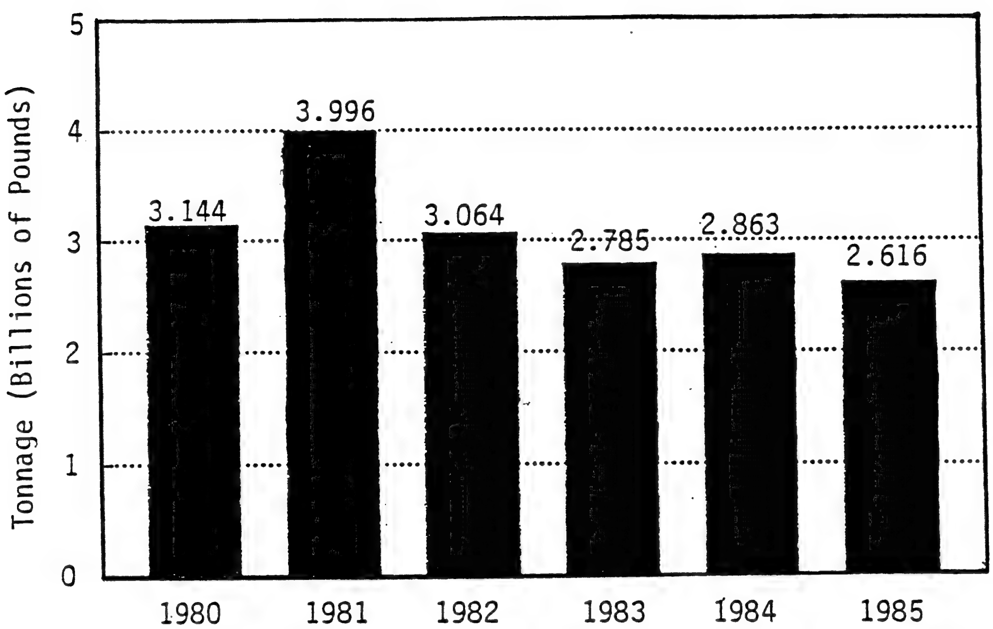
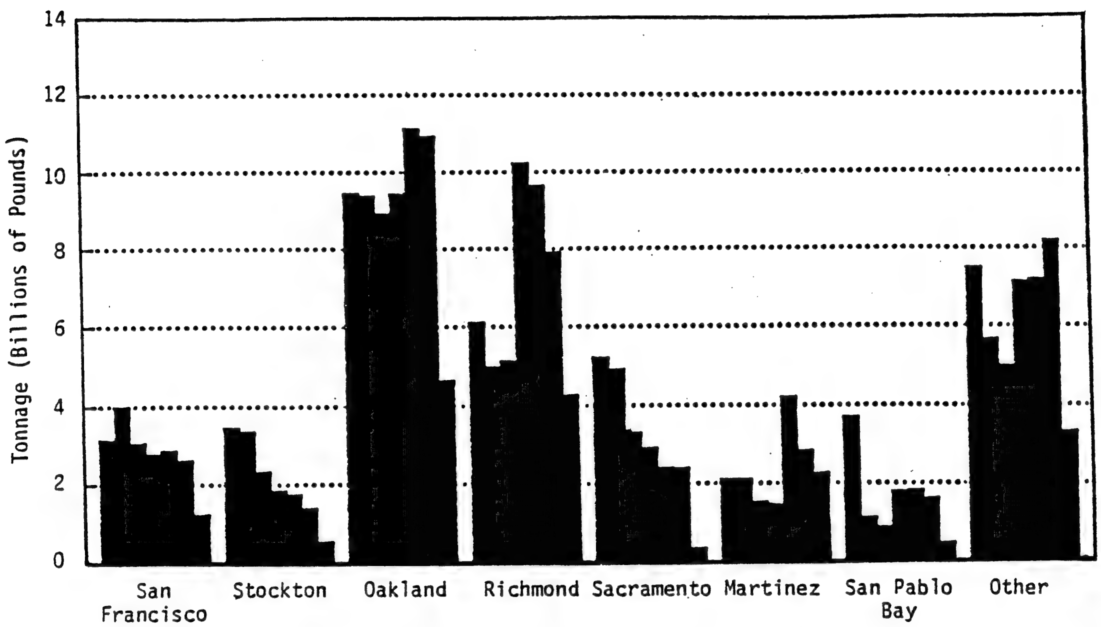


Chart 5 shows the total cargo passing through the major ports of the entire district from 1980 through May 1986, when the most recent cargo tonnage figures were available. During this period, cargo tonnage passing through the entire district declined 7 percent.

CHART 5

AMOUNTS OF CARGO SHIPPED THROUGH THE MAJOR PORTS OF THE SAN FRANCISCO CUSTOMS DISTRICT 1980 THROUGH MAY 1986



Note: 1986 figures are for the first five months only.

Port of San Francisco officials stated that they have concentrated on increasing cargo handled from liner services, which are offered by regularly scheduled shipping lines. In 1985 and the first five months of 1986, liner services represented approximately 55 percent of the total cargo shipped by the Port of San Francisco. In 1980, total liner tonnage shipped through the San Francisco customs district was 10.1 billion pounds. In 1985, the last full year for which statistics are available, total liner tonnage shipped through the district was 10.9 billion pounds, an increase of 7 percent. Liner tonnage shipped through the Port of San Francisco increased from 1.4 billion pounds in 1980 to 1.45 billion pounds in 1985, an increase

of 3 percent. Between 1980 and 1984, the Port of San Francisco's percentage of liner tonnage shipped through the San Francisco customs district decreased from 13.8 percent to 12.3 percent. In 1985, this percentage increased to 13.3 percent. Analysis of the most recent data available indicates that, as of May 1986, the percentage of liner tonnage shipped through the Port of San Francisco has increased to 14.8 percent.

Our analysis also shows that the Port's share of the value of cargo shipped through the San Francisco customs district since 1980 has remained relatively the same. The total value of cargo passing through the district in 1980 was $1.999 billion. In 1980, the Port ranked second with a 13.9 percent share of the cargo value shipped through its customs district. Through the first five months of 1986, the total value of cargo passing through the San Francisco customs district was $1.077 billion. As of May 1986, the Port still ranked second and maintained its share with 14.1 percent of the cargo value.

CONCLUSION

The United States Department of Commerce's figures indicate that since 1980 the San Francisco customs district has maintained its share of the total tonnage of cargo shipped through the customs districts of Seattle, Portland, San Francisco, Los Angeles, and San Diego although the district's tonnage has dropped 7 percent. These figures also

indicate that the San Francisco customs district has not maintained its share of the total value of cargo shipped through the five districts. Within the San Francisco customs district, the Port of San Francisco's share of total tonnage shipped through the district's ports has declined slightly since 1980. Nevertheless, the Port has maintained its share of the total value of the cargo shipped through the ports of the district. Further, although total tonnage through the Port has declined since 1980, the Port's liner tonnage and market share in the customs district have increased.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

Kurt R. Sjoberg

for THOMAS W. HAYES
Auditor General

Date: March 23, 1987

Staff: Samuel D. Cochran, Audit Manager
Mark A. Lowder
Paul J. Carrigan
Bahman Chubak
Katherine M. Weir
Susan L. Wynsen

PORT OF SAN FRANCISCO
FERRY BUILDING
CITY OF SAN FRANCISCO • DIANNE FEINSTEIN, MAYOR
SAN FRANCISCO, CALIFORNIA 94111 • TEL: (415) 391-8000
TELEX: 275940 PSF UR
CABLE: SFPORTCOMM

March 18, 1987

Mr. Thomas W. Hayes
Auditor General
California Legislature
660 J Street
Sacramento, CA 95814

Dear Mr. Hayes:

The Port feels that the audit report is the result of a very professional and thorough analysis of the facts. However, certain conclusions are reached with which the Port differs and we set forth in the attached response, the reasons for those differences.

I and my entire staff appreciate very much, the cooperation of you and your staff and the courteous and businesslike approach that was followed in completing this audit.

Sincerely yours,

Eugene L. Gartland
Port Director

Attachment

RESPONSE TO STATE AUDIT

The Port feels that the audit report is the result of a very professional and thorough analysis of the facts. However, certain conclusions are reached with which the Port differs. Our response includes clarification of some issues.

CHAPTER I - THE PORT OF SAN FRANCISCO CAN MEET ITS STATE GENERAL OBLIGATION BOND PAYMENTS

The Port firmly believes that it will be able to meet all its debt service obligations, including State General Obligation Bonds. The Port is willing to recommend to the Port Commission, that $3.8 million be reserved to provide comfort to the State. However, this should not be interpreted as agreement with the auditors' projections. The Port's own projections, historical record and budget policies assure that all of the Port's debt service obligations will be met. Additional comments regarding this issue are presented below.

The Development of the Ferry Building Complex

The Port agrees with the report's analysis and conclusions that by not redeveloping the Ferry Building Complex, under terms of the Continental Development Corporation agreement, that there will be no adverse affect on the ability of the Port to meet its state general obligation bond payments.

The Development of Piers 1 1/2, 3 and 5

The Port agrees with the report's analysis and conclusion, that not being able to develop this area "would adversely affect the ability of the Port to meet its state general obligation bond payments".

As the audit report states, the Port would receive more ($477,000) from the development of these piers than it does from current rentals ($250,000). The term "adversely affect" however, should not be construed to mean that the Port would lose money in the absolute sense. If the piers are developed, the Port would realize additional revenue.

Not gaining an additional $227,000 through the development of this project will have no significant effect on the Port's ability to meet its debt service obligations.

Deferred Maintenance at the Port of San Francisco

The Port agrees with the report's analysis and conclusion

that the "deferred maintenance should not adversely affect the ability of the Port to meet its state general obligation bond payments in the future". This is based on the ability of the Port to "ensure that its tenants fulfill their deferred maintenance obligations" and that "no additional deterioration occurs on the facilities scheduled for deferred maintenance work in the future".

The Port has set up a format that it is using to help ensure that tenants fulfill their deferred maintenance obligations. Any additional deferred maintenance not included in the current schedule can be accommodated by the Port's Maintenance Department and funded by its operating budget.

The Ability of the Port of San Francisco to Meet its State General Obligation Bond Payments

The Port firmly believes that it will meet all its debt service obligations, including state general obligation bonds. The Port is willing to recommend to the Port Commission, that $3.8 million be reserved to provide comfort to the State. This should not be interpreted as agreement with the auditors analysis. To the contrary, although we understand the reasons why the auditors used a "trend analysis" methodology in making their projections, we do not agree with the results of the trend analysis for the reasons identified below, which are included in the audit report:

* The Port has always made its debt service payments and revenues have always exceeded expenses in each year since the Port was transferred to the City & County of San Francisco in 1969.

* It is the policy of the Mayor's Office and the Port Commission that the Port's revenue budget must always be equal to or greater than the expenditure budget. All debt service requirements are included in the Port's operating budget.

* Many of the Port's expenditures are discretionary and could be reduced or eliminated if necessary.

* If the projections for revenues and expenses had been based on the period 1969 through 1986, it would clearly indicate that the Port's expenses would never exceed revenues.

* The Port's own projections of revenues and expenditures thru 1999 indicates that revenues will always exceed expenditures.

If the Port chose to pay the entire State bond debt immediately, it currently has the resources to do so, as

verified in the audit report. However, early payment would not be a prudent use of the Port's resources since interest rates on the State Bonds are 1.0 - 4.85%. In this appraisal we concur with the Auditor General.

Though we understand why this trend analysis methodology was used, historical data as a base for future estimates is not the only method, nor always the best method, for making projections. The auditors did make some adjustments for anomalies. However, many of the Port's expenses are discretionary and are not reflected in this type of estimate. In addition, some expenses increased at an unusually high rate during the base period, 1981 thru 1986. For example, insurance expenses increased by 118% during the base period to $1.5 million in 1986. However, budgeted insurance expenses will decrease in fiscal year 1987/88 by $480,000 as compared to the 1986/87 fiscal year. This was not taken into account in the trend analysis.

The Port has met all of its debt service requirements in each year since the State lands were transferred in 1969. This was true even in 1977, when the Port's net profit was only $76,660. The Port's net profit has exceeded $5 million for each of the last several years.

The Port believes that its projections are conservative, sound and attainable, and will allow for the payment of all future debt service.

CHAPTER II - THE PORT OF SAN FRANCISCO'S SHARE OF CARGO TONNAGE SHIPPED THROUGH BAY AREA PORTS HAS DECLINED SINCE 1980

We have reviewed the report regarding our maritime potential. We have no problem with the facts as presented. However, we would like to comment on the conclusions.

The study focused primarily on the issue of competitiveness as expressed in terms of cargo tonnage and cargo value. We understand the auditors' need to use an external data base to provide independent objectivity, but this approach overlooked other pertinent elements. The Port has five separate competitive maritime markets, namely: General Cargo, Bulk Cargo, Passengers, Ship Repair and Fishing. Analysis and conclusions based solely on the sum total of tonnage and value of dry and liquid cargo, does not tell the whole story. *

* The audit report distinguishes between liquid and dry cargo, whereas the Port divides the cargo market between general and bulk. General cargo (containers, etc.) has higher value than dry or liquid bulk.

San Francisco is first, among all Bay Area ports, in three markets (Ship Repair, Passenger, Fishing) which were not considered in the analysis. These three markets account for 37% of the Port's maritime revenue and each has excellent prospects for improvement as does general and bulk cargo.

General Cargo

The Port has made a conscious decision to target this market. Our marketing activities, solicitation and much of our construction has been aimed at promoting this market. Construction includes new cranes, terminal expansion, gate improvements, and most notably, our new on-dock Intermodal Container Transfer Facility which is aimed at US Midwest and East Coast traffic. We have chosen this market because of its growth opportunity and the cargo has a relatively high value-per-ton relationship. Between 1981 and 1986 we have seen positive results: containerization has increased by 115% and all general cargo, including newsprint and automobiles, has increased by 40%.

Bulk Cargo

Bulk cargo (petroleum, grains, wood chips, etc.), although impressive in tonnage, tends to be controlled on a proprietary basis and has a low value-per-ton relationship. Additionally, even when such cargoes are subject to being handled at different ports, the choice of port tends to be dictated by inland transportation costs and terms of sale. This accounts for the major growth of grain elevators on the US Gulf coast. San Francisco does not have land that is owned by major oil companies for refineries nor is it a competitive gateway for barge distribution. Our policy on bulk has been to treat inquiries for specialized movements on a case-by-case basis and to work with bulk interests to the extent that their proposed operations are compatible with our overall development.

Passengers

Cruise traffic through the Port has increased dramatically over the last five years. Fiscal year 1986 passenger levels were 10% higher than 1985 and 115% higher than 1982. Because of its central proximity to the Alaska/Canada and Mexico markets, San Franciaco has managed to "carve a niche" for itself in the cruise world -- coastwise cruises of seven days or more, as a stopover on extended cruises and, increasingly, as a cruise destination.

Two external conditions have also led to increased cruise traffic through San Francisco: the increasing

popularity and growth in the Alaska/Canada cruise market and the rise in domestic travel by Americans.

The Port anticipates that the expansion and redevelopment of our cruise terminal will further strengthen our competitive position vis-a-vis other west coast ports. Requests for proposals for potential development will be issued later this year.

Ship Repair

The Port of San Francisco now has the four top private ship repair companies in the Bay Area: Todd, Continental Maritime, Service Engineering and Southwest Marine. Our finger piers are ideal for top-side ship repair work. Those that are augmented with floating drydocks compete effectively for comprehensive work. With the City's and the Port's concerted efforts to restablish a major US Navy presence (the largest provider of ship repair work), our future in the ship repair market is excellent.

Fishing Industry

San Francisco is the leading wholesale fish receiving and distributing port on the West Coast, outside of Alaska. Over the past six years, commercial fisherman have landed an annual average of twenty million pounds with a value in excess of $8.5 million. The recently completed breakwater will permit construction of additional berths for which demand remains high. Furthermore, the development of new Hyde Street Pier as a fish handling facility will continue to keep San Francisco on top in this market.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps